



Y2K Newsletter

MMillennium

February 27, 1998

Volume 1, No. 2

An Examiner's Review of Preparedness

Reviewing the five stages of preparedness for the Year 2000 conversion, Jennifer Dickerson, OTS information systems examination manager for national Year 2000 programs, told a Washington, D.C., audience February 19 that thrift institutions should have completed the Awareness and Assessment stages by now and should be well into the Renovation phase of their conversion plans. The last two stages are Validation and Implementation. Ms. Dickerson was one of the speakers at a conference on the Year 2000 sponsored by the ACB, FDIC and OTS.

In the assessment stage, she reminded her audience, management should have reviewed the size and complexity of the problem, checked inventory systems, reviewed connectivity and interdependencies of the systems, as well as licensing agreements, performed a legal audit and reviewed efforts by significant vendors used by the institution. Management also should have assessed business interrelationships and considered the impact of Y2K on strategic business initiatives, such as small business and commercial lending and credit card activities.

Once that was done, institutional management needed to prioritize the systems noted in the inventory and determine strategies to be used to implement Y2K corrections. Institutions also should have identified resource requirements, assigned accountability for the project tasks and developed management policies, Ms. Dickerson said.

As important as any other measures that should comprise current activities at institutions is the development of a contingency plan in case a service provider isn't ready or the institution's own systems renovation fails on any critical date. What do you do in that instance? If an institution has prepared itself for such a contingency, it should be able to resort to a manual system or execute back-up support it has arranged through contracts for this purpose, she said.

Contingency planning, Ms. Dickerson said, requires serious effort by institutions. They need to address mission critical issues and prioritize remaining applications. They should establish trigger dates covering such activities as systems conversion time and staff training time, and undertake quarterly reviews of and adjustments to alternative plans of service providers. She said that if an institution needs help in contingency planning, its management can consult with user and trade groups, for example.

The third stage of preparedness cited by Ms. Dickerson is renovation. This is the nuts and bolts stage where all the code enhancements in an institution's computer systems,

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hardware and software upgrades and system replacements, if necessary, take place. To carry out the renovation successfully, the institution will have a compliance strategy in place for each system. The choices management will have to make are: Do you retire the system because it cannot be reasonably or cost-effectively renovated? Do you instead outsource the service? Must you replace it; or can you renovate it? While it is necessary to take this approach with each system, management also has to understand how the systems all fit together. At this point, institutions should be well into their renovation efforts.

Next comes the validation phase, the most time-intensive period of the preparedness cycle. She said institutions should expect that validation will consume half to 60 percent of the whole project's attention. Management must make available the funds and the human resources that will be required to do this part of the job, she emphasized.

Testing must follow a formal plan, and the institution must maintain good communications with any service providers and software providers and ensure that they are prepared with their own testing plans and specific testing dates. Senior management should monitor testing progress of all mission critical applications. The objective is to thoroughly test all internal and external systems and make certain the testing includes all systems that share information.

Finally, Ms Dickerson said, comes implementation, the last stage of preparedness for the Year 2000 conversion. First of all, management should approve the conversion schedule with the knowledge that the thrift's systems have virtually arrived at that point. Once the conversion actually occurs, the institution needs to update operating procedures, software backups and disaster recovery plans as required by the new operating system.

Director Seidman Testifies; House Passes Access Bill

Shortly after OTS Director Ellen Seidman testified on February 5 before the House Banking Committee, urging Congress to give OTS statutory authority to examine service providers to thrift institutions, the committee passed a bill that would do just that. On February 24, the full House adopted the bill, and the Senate was to take up a similar bill as this newsletter went to press. The House legislation provides two key features supported by OTS:

- Calls on OTS and the other federal banking agencies, including the National Credit Union Administration, to continue developing guidance on the Year 2000 conversion; and
- Grants both OTS and the NCUA statutory parity with the other federal banking agencies in the oversight of service providers. The House set a sunset date of December 31, 2001, on the NCUA's authority, but did not impose any sunset on OTS' authority.

The legislation gives OTS the right to examine a group that provides thrift institutions, particularly smaller ones, data processing of critical business applications. While OTS generally has been able to gain access to the service providers by requiring thrifts to obtain the consent of the providers to be examined, Ms. Seidman pointed out to the Banking Committee, that some servicers had nonetheless been resistant in the past to allowing OTS to examine them.

The House measure (Examination Parity and Year 2000 Readiness for Financial Institutions Act) has the objective of protecting the safety and soundness of depository institutions. It calls upon the federal banking agencies to conduct seminars and provide guidance for regulated institutions on the implications of the Year 2000 computer problem. In particular, it requires the agencies to explore and identify appropriate approaches to common Year 2000

computer problems with respect to project management, service contracts, testing regimes and business continuity planning.

Ms. Seidman told the committee that OTS welcomes these responsibilities, and is, in fact, already doing much of what the legislation requires. Primary responsibility and liability of compliance rests with the institutions themselves, she said, including those that rely on service providers. She reviewed for the committee a number of activities currently underway.

OTS information systems examiners are currently conducting examinations of the Multiregional Data Process Servicers (DMPS) data centers and the Shared Application Software Review (SASR) bank software providers, she said. The SASR program covers turnkey systems, stand-alone customer software and integrated packages. To complete these examinations effectively, she said a task force of seasoned examiners from each of the banking agencies was assembled to develop a process to complete these examinations by June 1998. The targeted companies, she said, provide more than half the core data processing products and services used by the banking industry. *(Note: As mentioned in a following article, OTS is conducting regular safety and soundness examinations either separately or concurrently with Year 2000 examinations, depending on scheduling).*

She also reported on the progress of the Federal Financial Institutions Examination Council (FFIEC) working group, including its development of policy statements issued to the banking industry, advisory letters to directors and senior management, formal presentations to the industry and direct contact with and counseling of regulated institutions through the examination process.

Besides the direct contact with institutions afforded by the examinations now underway, Ms. Seidman listed various OTS communications activities, including the posting of information in a Year 2000 site on the OTS web page, this newsletter and conferences, such as the "Countdown 2000: Is Your Bank Really Ready?" The first of three sessions was held in Washington (see Jennifer Dickerson's remarks) while the next two were scheduled for February 26 and 27 in Los Angeles and March 9 and 10 in Chicago.

Two Surveys: Point to Pluses and Minuses

America's Community Bankers' recent survey of members asking about their focus on the Year 2000 issue came up positive, showing "the overwhelming majority of community banks are focusing significant resources on resolving Year 2000 computer issues," both internally and at their third party service providers.

Another survey by the accounting firm, Grant Thornton, questions whether community banks have adequately budgeted for the Year 2000 problem, pointing out that its survey results show that half of all community banks surveyed plan to spend \$100,000 or less this year on correcting computer problems, compared with nearly three-fourths that expended this amount in 1997. The survey also pointed to other shortcomings, such as lack of contingency planning by two-thirds of the surveyed institutions.

The ACB survey appeared to confirm that a problem of understanding costs does exist. ACB said only 40 percent of respondents provided an estimate of the out-of-pocket costs associated with the Y2K problem. Others indicated they don't have a budget or can't estimate the costs of the problem. Nearly 90 percent of respondents with less than \$100 million in assets estimated their total costs to correct the problem would be under \$100,000. On the other hand, those with assets over a billion dollars estimated costs of conversion would exceed \$1 million.

The ACB survey did find that a significant percentage of respondents have a formal plan of conversion, and nearly all have assigned a senior staff member to oversee computer and systems renovations and discuss action plans with their directors on a regular basis.

Of the institutions relying on service bureaus for their transaction-related data process needs – a group that includes the majority of ACB members – nearly half said they are “extremely confident” that their service bureau will be ready on a timely basis, and another group of about 48 percent said they are “reasonably confident” that their servicers will be ready on time. Only a handful said they are not at all confident of readiness.

The survey showed, however, that only one-third of those responding have a plan for assessing Year 2000 risk for their business customers. And while two-thirds of the survey respondents said they have a contingency plan in hand or one under development, one in three does not. This reveals a shortcoming that is particularly pronounced for institutions with less than \$500 million in assets, the ACB reported.

Grant Thornton’s survey showed that about two-thirds of the institutions it questioned were without a contingency plan to deal with an interruption in their major suppliers’ businesses. The survey also revealed that 80 percent do not know how their major borrowers are addressing the Y2K issues.

ACB surveyed 1,450 member institutions in December 1997, and received 600 responses for a return of more than 40 percent. Grant Thornton sent questionnaires to more than 5,000 community banks and also received 600 responses.

Year 2000 Examinations; Second Wave

The inaugural edition of the *MMillennium* discussed the results of the off-site examinations OTS conducted in 1997 and briefly mentioned a second wave of Year 2000 examinations underway. This article explains more about that second wave.

Last summer and fall, OTS examiners used materials submitted by thrifts to conduct off-site supplemental examinations. These examinations focused on the first two phases in the Year 2000 project management plan as described by the Federal Financial Institutions Examination Council (FFIEC). That is, the examiners evaluated thrift management’s “Awareness” and “Assessment” of Year 2000 matters.

The information submitted by thrifts was also used to prioritize and plan another wave of examinations to be conducted on-site by June 30, 1998. These examinations are to focus on the third phase of the Year 2000 project management plan – “Renovation,” but examiners will also follow up on any open items from the off-site examinations, and will look at the institution’s plans for testing and other matters identified in the FFIEC Year 2000 examination program. That program was an appendix to the FFIEC’s May 1997 policy statement, “Year 2000 Project Management Awareness,” which was forwarded to the thrift industry by OTS in CEO Letter #67. The policy statement is available on our web site at www.ots.treas.gov/y2k.

Most of the second wave of Year 2000 examinations are scheduled to be completed between February and May. The Year 2000 examination work may be conducted concurrently with a regular or full-scope examination by our safety and soundness (S&S) examiners or information systems (IS) examiners, or it may be conducted as a separate special examination or field visit by examiners of either discipline.

As we do with other examinations, we are sending out a Preliminary Examination Request Kit (PERK) about one month in advance of the on-site examination asking thrift managers to prepare and assemble information the examiners will need. Items requested include, but are not limited to, copies of (a) the institution's Year 2000 Action Plan or updates if the plan was previously submitted; (b) the most recent status or progress report submitted to the board of directors. For institutions with in-house data centers, additional materials may be requested.

Because on-site Year 2000 examination work is expected to take just a few days in most cases, it is important that the materials be ready when the examiners arrive and that key officers are available for discussion. Please contact the field manager or other OTS representative identified in the PERK letter as soon as possible if the information request or examination schedule poses problems.

If your institution is using the OTS Year 2000 Checklist, available on the OTS web page and being updated, the examiners may ask to review any institution reports that reflect completion of tasks and/or percentages generated by the checklist. If not, the field manager or examiner-in-charge (EIC) may provide a copy and suggest that the checklist be completed. Nonetheless, the decision as to whether or not to use the checklist is thrift management's call. As provided in FFIEC's December 1997 policy statement, "Safety and Soundness Guidelines Concerning the Year 2000 Business Risk," issued by OTS as CEO Letter #76, OTS and other banking regulators require directors to actively monitor their institution's progress toward Year 2000 preparedness, but the agencies have not prescribed a standard format for such monitoring and reporting.

At the completion of field work, a report of examination (ROE) on Year 2000 matters will be prepared for the board of directors. If appropriate, the field manager or EIC will arrange to present the findings at a meeting with the board of directors or audit committee. If necessary, the field manager or EIC may also schedule a follow-up examination or field visit three to six months later to check progress toward correcting problems or weaknesses.

Year 2000 Rating

The EIC will assign a Year 2000 rating and disclose it to directors in the ROE. The rating and their definitions are the same as those being used by the other banking regulatory agencies. The three ratings are "Satisfactory," "Needs Improvement" and "Unsatisfactory." Their definitions are as follows:

SATISFACTORY
<p>Year 2000 efforts of financial institutions and independent data centers are considered "Satisfactory" if they exhibit acceptable performance in all key phases of the year 2000 project management process as set forth in the May 5, 1997 FFIEC Interagency Statement on the year 2000 and subsequent guidance documents. Performance is satisfactory when project weaknesses are minor in nature and can be readily corrected within the existing project management framework. The institution's remediation progress to date meets or nearly meets expectations laid out in its year 2000 project plan. Senior management and the board recognize and understand year 2000 risk, are active in overseeing institutional corrective efforts, and have ensured that the necessary resources are available to address this risk area.</p> <p>Independent Data Centers The program of a data center evaluated as "Satisfactory" should have the strengths identified above. A satisfactory evaluation is appropriate if the data center also is actively communicating with client banks and makes its year 2000 project objectives and benchmarks available to them.</p>
NEEDS IMPROVEMENT
<p>Year 2000 efforts of financial institution and independent data centers are evaluated as "Needs Improvement" if they exhibit less than satisfactory performance in any of the key phases of the year 2000 project management processes outlined below. Project weaknesses are evident, even if deficiencies are correctable within the existing project management framework. The institution's remediation progress to date is behind the schedule laid out in its year 2000 project plan. Senior management or the board is not fully aware of the status of year 2000 corrective efforts, may not have committed sufficient financial or human resources to address this risk, or may not fully understand year 2000 implications.</p> <p>Independent Data Centers Program weaknesses identified above should be reflected in a data center evaluated as "Needs Improvement." This evaluation may also be appropriate if vendor communication with client banks is sporadic or if project objectives and benchmarks are difficult to obtain.</p>
UNSATISFACTORY
<p>Year 2000 efforts of financial institutions and data centers are "Unsatisfactory" if they exhibit poor performance in any of the key phases of the year 2000 project management process outlined below. Project weaknesses are serious in nature and are not easily corrected within the existing project management framework. The institution's remediation progress to date is seriously behind the schedule laid out in its year 2000 project plan. Senior management and the board do not understand or recognize the impact that the year 2000 will have on the institution. Management or the board commitment is limited or their oversight activities are not evident.</p> <p>Independent Data Centers When a data center exhibits program weaknesses identified above, it should be evaluated as "Unsatisfactory." This evaluation may also be appropriate if a data center's communication with client banks is unclear and inaccurate, or if project objectives and benchmarks are not available.</p>

Similar ratings definitions are being used for independent data centers, also known as vendors, service bureaus and the like.

Enforcement

Thrift managers have asked about the likely regulatory ramifications of ratings of "Needs Improvement" and "Unsatisfactory." OTS policy relative to these ratings will be a subject covered in a subsequent issue of this newsletter. However, you should be aware that the agency expects timely resolution of the underlying weaknesses or concerns leading to the ratings, and will consider initiating enforcement action when necessary.

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OTS will periodically update its Year 2000 section on its web page, including a version of this newsletter, in the ongoing program to provide helpful information. The web site also links to other pertinent web sites such as that of FFIEC. You can access the OTS page at www.ots.treas.gov. The web page Y2K section currently includes, among other things, the FFIEC Y2K guidelines that were issued in December and the checklist for monitoring progress in your Y2K plan.

Other web sites of possible interest to readers are those of America's Community Bankers (ACB) at www.acbankers.org and the Independent Bankers Association of America (IBAA) at www.ibaa.org.

You may also find a publication of the American Institute of Certified Public Accountants (AICPA) helpful in assessing your Y2K program. This 40-page publication, entitled "The Year 2000 Issue: Current Accounting and Auditing Guidance," provides a brief overview of the Y2K issue, and summarizes the applicable accounting, disclosure and auditing standards. The publication relates the responsibilities of various parties, clarifies the auditor's role, provides guidance on auditor communications with clients, and describes disclosure considerations and certain practice management matters that auditors may wish to consider in connection with the Year 2000 issue. The publication is available on the AICPA's web page at www.aicpa.org and can be obtained from the AICPA through its toll-free number (800) 862-4272.